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TAGS: ECON EFIN ETRD PREL PK
SUBJECT: Central Bank's Third Quarter Report - Growth Fragile, Inflation Stubborn

¶1. (SBU) Summary: On June 4, the State Bank of Pakistan released its third quarterly report (through March 30), which projected GDP growth for the fiscal year at 2-3 percent, a prediction unchanged from the previous quarter. Large-scale manufacturing, the engine that funds tax collection, fell by almost 8 percent in the first nine months of the fiscal year. Inflation has remained stubbornly high - year on year over 17 percent as of April, compared to an IMF target of 11 percent, although food inflation has come down sharply from 34 percent to 17 percent. Inflation, deterioration in external accounts, and declining industrial output have all contributed to lower growth, although this is offset to some extent by the strong performance of the agricultural and services sectors. Although overall macroeconomic indicators have continued to improve since November (the current account deficit, foreign exchange reserves, the exchange rate, fiscal discipline), major economic weaknesses persist and could hamper economic recovery. End Summary

¶2. (SBU) Agriculture and Services Perform: The State Bank of Pakistan's third quarterly report predicts that the agriculture sector will perform quite well, as evidenced by record wheat and rice harvests and the prospect of good overall yields in lentils, oilseeds, and horticultural crops. These high growth rates are due to higher government purchase prices and favorable weather, although there has been lower water availability and a decline in fertilizer usage. The livestock sector benefited from improved fodder, following the extended monsoon and winter rains, as well as the absence of any major outbreaks of disease during FY09. Notwithstanding a slowdown in the trade, transportation and communication sub-sectors, the services sector overall is also expected to perform well.

¶3. (SBU) Manufacturing Slumps: In March, growth in large-scale manufacturing (LSM) was negative for the tenth consecutive month. LSM growth dropped by 7.6 percent from July through March, compared with a 5 percent increase a year earlier. This remains a major drag on prospects of improving real GDP growth. While the decline in LSM growth is a reflection of weaker domestic and external demand, other domestic factors have contributed significantly as well: infrastructure bottlenecks (e.g., power and gas shortages), increasing risk aversion by banks, and persistent inflation.

¶4. (SBU) Stubborn Inflation: Headline inflation - measured by the consumer price index (CPI) - dropped to a 17.2 percent annual basis

in April from its peak of 25.3 percent in August 2008. In particular, a sharp decline in food inflation, from 34.1 percent in August to 17.0 percent in April, provided relief to the poorest sectors of society. The decline in inflation was due to favorable international prices, as well as a slow-down in domestic demand. The latter, in particular, reflected the State Bank's monetary tightening, as well as the complementary improvement in fiscal discipline since November 2008.

¶5. (SBU) By April 2009, broad money growth (time deposits, current deposits and currency in circulation) was still quite weak, at 1.9 percent year-to-date, down sharply from 8.4 percent in the same period last year, reflecting the continued fall in domestic demand. Because of this, the SBP projects the drop in inflation will be even sharper in the next few months.

¶6. (SBU) Tax Receipts Fall Short: Recent discussions with Ministry of Finance officials indicate that the budget deficit for the first three quarters of FY09 is likely to be 3.1 percent of GDP, compared with 4.7 percent in the same period last year. There will likely be a shortfall in tax receipts for FY09 as well; in the first ten months of the fiscal year, tax receipts amounted to $11.23 billion, compared with $9.54 billion in the same period in 2008, an increase of almost 18 percent. This falls short of the 24 percent growth required to attain the IMF's target of $15.6 billion for the fiscal year. As of April 30, total tax collection had reached 71.9 percent of the year end target.

¶7. (SBU) Current Account Improves; Capital Accounts Deteriorate: The improvement in Pakistan's overall external account that began in

November 2008 has continued. A large part of this is due to the 23.5 percent contraction in the current account deficit, primarily due to a fall in imports. Unlike the improvement in the current account, however, capital and financial accounts deteriorated sharply during the first ten months of FY09. While loan inflows revived to a large extent after IMF Stand-By Arrangement, foreign investment inflows continue to decline.

¶8. (SBU) Foreign Exchange Reserves Up: The relative improvement in Pakistan's external accounts was reflected in its foreign exchange reserves, which have gradually improved since the Stand-By Arrangement was agreed. By April 30, foreign exchange reserves had returned to the level of end-June 2008, or $11.4 billion, after hitting a low of $6.8 billion in October 2008. This also alleviated pressure on the exchange rate, helping it to stabilize between 78.8 and 80.86 rupees per dollar.

¶10. (SBU) Fiscal Deficit Under Strain: The fiscal deficit for the year through March was reported at 3.1 percent of GDP, which is consistent with the annual target, but there are significant issues with the sustainability of this trend. The growth in tax collections has already slowed, and may decline further in the fourth quarter of FY09. Non-tax revenue receipts are also expected to weaken. Rising international prices are expected to diminish the proceeds of the Petroleum Development Levy, for example, which had supplied the GOP with billions of rupees in revenue over the past year as domestic oil prices were not lowered along with international prices. The government's expenditure budget will also be stretched by the ongoing war on terror and the need to support internally displaced persons (IDPs) fleeing the conflict areas. The current improvement in the fiscal picture is the result of a temporary sharp cut on development spending, which is neither sustainable nor desirable in the long term.

¶11. (SBU) Comment: The State Bank of Pakistan's economic reports are highly regarded by multilateral agencies and academics due to their independent assessment of the economic situation. The current report characterizes the improvement in macro-economic indicators as "tenuous" and rightly points out underlying risks. For example, gains in the current account balance can be eroded quickly if remittances falter and there are further drops in foreign investment. There will likely be more slippage in the fiscal deficit targets if tax collection efforts do not improve. The level of international commodity prices plays a large role in Pakistan's

fight against inflation, and increases in electricity prices mandated by the IMF will also contribute to inflationary pressures.

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